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IN THE

Supreme Court of the United States

October Term, 1977
No. 77-279

ROYAL INDUSTRIES, and PLAS-TIES SUBSIDIARY,

Petitioners,

vs.

ST. REGIS PAPER COMPANY,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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ST. REGIS PAPER COMPANY,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Petitioner Royal Industries respectfully requests that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered on April 19, 1977.

Opinion Below.

The opinion of the Court of Appeals, reported at 194 USPQ 52, appears in a separate appendix to this petition as Exhibit A.

Jurisdiction.

The judgment of the Court of Appeals was entered on April 19, 1977. On July 8, 1977, Mr. Justice Rehnquist extended the time to file this petition until August 18, 1977. Jurisdiction of this court is invoked under 28 U.S.C. 1254. Jurisdiction in the District Court was based on 28 U.S.C. sections 1332, 1338 and 2201.

Statement of the Case.

This case involves a licensing agreement (Appendix, Exhibit B) entered into between the St. Regis Paper Company ("St. Regis") and Royal Industries and its Plas-Ties Subsidiary (hereinafter collectively referred to as "Royal") on May 1, 1963 whereby St. Regis obtained the right to use the so-called Bower patent owned by Royal, and Royal's know-how for the purpose of manufacturing plastic tie strips for use in the bakery industry. St. Regis agreed to pay Royal a royalty of 10% of its net sales of the plastic tie strips. This royalty was computed on the basis of 5% for the patent rights and 5% for the know-how (March 31, 1963 letter from J. R. Johnson, president of Royal to Leslie J. Jacobs of St. Regis' Pollock division (Appendix, Exhibit C). The parties contracted with reference to the possible invalidity of the Bower patent. This is reflected in section 12(b)(1) of the license agreement of May 1, 1963 which reads as follows:

> "12. This agreement shall terminate upon the expiration of United States Patent No. 2,767,113,

which is October 16, 1973, unless sooner terminated as hereinafter provided . . .

"(b) Pollack may terminate this agreement after the expiration of three years from the effective date of this agreement by serving six months written notice on Royal to that effect in the event that:

"(1) Said Patent No. 2,767,113 is held invalid or so restricted in scope as to substantially lessen the protection of said patent by the final judgment of a court from which no appeal has been or can be taken; or . . ."

St. Regis paid Royal the royalties called for in its contract in the total sum of $174,642.04 until July 19, 1967. St. Regis discontinued paying any royalties for either its use of the Bower patent or Royal's know-how after that date because St. Regis claimed that it had evidence which tended to establish that the Bower patent was invalid.

On April 24, 1968, St. Regis brought this action against Royal to declare the Bower patent invalid, to rescind the license agreement and to recover the royalties paid. Royal counterclaimed for patent infringement, for a declaration of rights under the licensing agreement, and, in any event, for the accumulated royalties due for St. Regis' use of its know-how.

Although St. Regis discontinued the payment of any royalties after July 19, 1967, it continued to manufacture the plastic tie strips using the method protected by the Bower patent and also using Royal's know-how. St. Regis admitted that, during the time that it withheld royalty payments from Royal until October

6, 1973, when the Bower patent expired, it would have owed Royal royalty payments of $322,426.57.

The judgment of the District Court holding the Bower patent invalid was rendered on July 19, 1974, more than nine months after the license agreement had terminated and the Bower patent had expired.

Proceedings Below.

The District Court ruled that the Bower patent was invalid and that St. Regis could rescind the license agreement of May 1, 1963, but denied either St. Regis or Royal a money judgment against each other. The District Court held that Royal was entitled to the reasonable value of its know-how, but, instead of directing St. Regis to pay Royal the agreed royalty for the know-how of 5% of the net sales of the plastic tie strip, the Court, without any evidentiary support in the record, valued Royal's know-how at $53,088.90. The Court further held that this sum has been paid to Royal in the form of one-half of the royalties paid by St. Regis through the second quarter of 1965 after which time the value to St. Regis of Royal's know-how had become *de minimis*.

The Court of Appeals affirmed the judgment of the District Court in all respects.

Questions Presented.

1. Does the *Lear* doctrine render unenforceable a patent license agreement in which the parties contract with reference to the possible invalidity of the patent?

2. Where a license agreement calls for payment of royalties for the use of both the licensor's patent rights and the licensor's know-how and the patent is

held to be invalid, does the District Court have the power to convert the contract for the know-how from a royalty contract into a lump sum contract?

3. Where a licensee to a patent license agreement has been given the full protection that he bargained for during the term of the license agreement, should the licensee be entitled to withhold royalty payments under the doctrine of *Lear v. Adkins*, 396 U.S. 652 (1969) where the patent in question expired before it was determined to be invalid?

REASONS FOR GRANTING THE WRIT.

The court below has decided important questions of federal law which have not been but should be settled by this court.

1. Does the Lear Doctrine Render Unenforceable a Patent License Agreement in Which the Parties Contract With Reference to the Possible Invalidity of the Patent?

Lear v. Adkins, supra, dealt with the usual patent licensing agreement in which the parties contract with reference to a presumptively valid patent. The licensee bargains for the monopoly protection afforded by the patent; the licensor warrants the validity of the patent and agrees to hold the licensee harmless from any infringement suits. A valid patent is the subject matter of the contract. If the patent is invalid, there has been a total failure of consideration. The licensee should never have had to pay any royalties in the first place for the use of something that was properly in the public domain.

Lear laid to rest the doctrine of licensee estoppel. Although it further held that the licensee could withhold royalty payments *pendente lite,* later decisions hold that, if the licensee wishes to continue to invoke the protection of the license agreement, he should be required to continue paying royalties to the licensor *pendente lite. Warner-Jenkinson Co. v. Allied Chemical Corp.,* ..... F.2d ....., 193 USPQ 753 (2d Cir. April 13, 1977).

However, an entirely different set of values comes into play where the owner of a patent is not certain whether or not his patent is valid and where a prospective licensee does not particularly care whether or not

the patent is valid. For reasons of his own choosing, the prospective licensee desires the protection afforded by the patent even though it recognizes that the patent may ultimately be held invalid.

This was the situation that obtained in this case. St. Regis was not particularly interested in whether or not the Bower patent was valid. It was most anxious to get into the new business of wrapping bakery products with a tie strip around one end of the package. As stated by the Court of Appeals, "St. Regis lacked the technical ability to manufacture tie strips. The Bower tie strips and the machines Bower developed were suitable for bakery packaging." Indeed, St. Regis' first approach to Royal was to purchase the entire Plas-Ties operation from Royal. When Royal would not sell, St. Regis was happy to enter into the license agreement in question for the use of the Bower patent and Royal's know-how. St. Regis' indifference to the validity of the Bower patent is evidenced by the fact that all it was was an *option* to terminate the license agreement on six months notice should the Bower patent be declared invalid. This is reflected in section 12(b)(1) of the license agreement quoted above. The District Court held this clause of the agreement unenforceable under *Lear*.

Royal respectfully suggests that it is an unwarranted extension of *Lear* to hold that sophisticated businessmen cannot contract with reference to the possible invalidity of a patent. It is undoubtedly true that most often the *sine qua non* of a patent licensing agreement is the validity of a patent. However, in those instances in which the validity of a patent is not of overruling importance, parties should be free to contract as St. Regis and Royal did in this case. There should be

no knee-jerk application of *Lear* to every single patent license agreement. As a matter of fact, a respected commentator has suggested that *Lear* requires considerable clarification. See "Unmuzzling the Patent Licensee: Chaos in the Wake of Lear v. Adkins", 45 George Washington Law Review 429 (1977).

In a case such as this one, where the patent rights were but one of the many things that St. Regis desired from Royal, *e.g.*, in the language of the Court of Appeals ". . . knowledge of how the machinery used to manufacture plastic tie strips was constructed, and how this machinery operated. It included detailed information of the process for manufacturing the patented tie strips, a list of material suppliers, and work room dimensions. An employee of St. Regis spent several weeks at Royal's plant studying the manufacturing process" (slip opinion p. 12) and where even the validity of the patent was not essential to the parties, a licensee should not be permitted to use *Lear* as a sword to avoid his contractual obligations, particularly where, as here, that licensee has received everything that he bargained for in the contract.

2. Where a License Agreement Calls for the Payment of Royalties for the Use of Both the Licensor's Patent Rights and the Licensor's Know-how and the Patent Is Held to Be Invalid, Does the District Court Have the Power to Convert the Contract for the Know-how From a Royalty Contract Into a Lump Sum Contract?

Know-how is an important property right. Its use may command the payment of a substantial premium in the market place. Royal places a great value on know-how for the manufacture of its laminated plastic

tie strips. St. Regis, had it chosen to do so, could have obtained a license from Royal to use the Bower patent and developed its own know-how. However, it desired to obtain the use of both Royal's know-how and the Bower patent; hence, it entered into the license agreement in question. Furthermore, St. Regis has never once complained that it failed to get what it bargained for from Royal. It found Royal's know-how helpful in enabling it quickly to get into the production of the plastic tie strips in question. The words "patent rights" and "know-how" are used in tandem throughout the license agreement; furthermore, St. Regis has exploited the patent rights and the know-how continuously since the execution of the license agreement on May 1, 1963.

Because of this, the Court of Appeals labelled the patent rights and know-how as "intimately intertwined" and enunciated a new rule that, if the royalties for the patent rights are uncollectible under *Lear,* the "same rule . . . should apply with equal force to know-how." To follow the Ninth Circuit's reasoning that the patent rights and the know-how are "intimately intertwined" places the know-how in the public domain along with the nonpatentable subject matter and thereafter rendered nonroyalty bearing. This is contrary to the facts and the law. St. Regis never complained that there was practically no distinction between know-how and the patent rights.

This is a harsh rule unwarranted by the facts. There is no public policy in favor of the widespread dissemination of one's know-how. Indeed, the law recognizes the right of a citizen to keep his know-how a secret if he so desires, even if it is patentable subject matter,

and further recognizes that trade secrets of this kind are an appropriate subject for a royalty agreement; *Kewanee Oil Co. v. Bicron Corp.* (1974) 416 U.S. 470, 487; 181 USPQ 673, 680. *Components for Research Inc. v. Isolation Products, Inc.*, 241 Cal.App.2d 726, 729, ... P. 2d ....; *Futurecraft Corporation v. Clary Corp.*, 205 Cal.App.2d 270, 289-290, ... P. 2d ....; *Painton and Company v. Bournes, Inc.* (April 27, 1971 2d Cir.), 442 F. 2d 216, 169 USPQ 528.

There is no legitimate reason why a citizen should be deprived of the benefits of his contract concerning know-how just because a patent which was involved in that contract was declared invalid. The Court of Appeals stated: "In our view, the patent rights and know-how here are so intertwined that it would be unreasonable to enforce the agreement for one and not the other" (slip opinion p. 13).

The Court of Appeals assumed that it was not possible in this case to distinguish "between royalties for patent rights and royalties for know-how". However, before such a harsh result should be visited upon the licensor, the trier of fact should be directed to ascertain how much of the agreed royalty was attributable to the know-how. This determination would have been a simple one in this case. The background out of which this license agreement was negotiated clearly establishes that the 10% royalty was based upon 5% for the patent rights and 5% for the know-how.

However, even in those cases in which the delineation between the amount of the royalty payments attributed to the patent rights and the amount attributed to the know-how is not clearly set forth, the court should not have the power to convey a royalty contract into

a lump sum contract as the District Court did in this case. Its power should be limited to determining as a matter of fact how much of the total royalty payment is chargeable to the know-how and direct the payment of that percentage of the agreed royalty to the licensor.

In short, the federal judiciary does not have the power to rewrite private contracts. This is an important federal question. This court should grant certiorari for the purpose of issuing an opinion to the effect that the lower courts cannot under the guise of pronouncing that which is "reasonable" deprive a party of his contractual rights. Royal bargained for royalty payments for the use of its know-how and it is entitled to those payments.

The function of a District Court is to interpret contracts, not rewrite them.

3. Where a Licensee to a Patent License Agreement Has Been Given the Full Protection That He Bargained for During the Term of the License Agreement, Should the Licensee Be Entitled to Withhold Royalty Payments Under the Doctrine of Lear v. Adkins, Supra, Where the Patent in Question Expired Before It Was Determined to Be Invalid?

Lear and its progeny stand for the proposition that a licensee should not have to pay royalties for the right to use an invalid patent. In the case at bar, St. Regis was permitted to suspend royalty payments *pendente lite*. In *Warner-Jenkinson v. Allied Chemical Corp., supra,* the licensee was not permitted to suspend the royalty payments *pendente lite,* but nevertheless, the court held that, should the patent be held invalid, the licensee ". . . would become

entitled to withhold future royalties and to receive restitution of royalties paid pendente lite (with interest)."

However, in the case at bar, the license agreement terminated on October 16, 1973, the date on which the Bower patent expired. The patent was not declared invalid until nine months later on July 19, 1974.

During the entire period of the license agreement, St. Regis enjoyed the full protection of the Bower patent as if it were valid. It received the full consideration that it bargained for. As stated in *Moraine Products v. ICI American Inc.*, 191 USPQ 65 (7th Cir. June 18, 1976) at page 77, that licensing arrangements in the final analysis ". . . are agreements in which the licensee is purchasing the right to be free from infringement litigation . . ." St. Regis obtained this protection for the full term of the license agreement.

Lear stands for the proposition that a licensee may assert patent invalidity as a defense to a contract action for the nonpayment of royalties. However, where the licensee has enjoyed the full protection of the patent for the full term of the license agreement, he should not be able to avail himself of *Lear* to avoid paying the royalties due under the license agreement. *Lear* assumes a failure of consideration. There is no failure of consideration when a patent is declared invalid after the expiration of the agreement. This Court should resolve the conflict between the Ninth Circuit in the case at bar and the Second Circuit in *Warner-Jenkinson* as to whether or not a licensee can withhold payments *pendente lite*, by following the ruling of the Second Circuit that, if he avails himself of the benefits of the license agreement, the licensee must pay the royalty payments *pendente lite*.

This Court should further declare that, if the licensee has had the full benefits of the license agreement during the term of the license, *Lear* does not permit the licensee to have restitution of any of the royalty payments if the patent is held to be invalid *after* the license agreement has terminated.

Conclusion.

For the reasons stated above the petition should be granted.

Respectfully submitted,

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Of Counsel:
EDWARD J. DARIN,

August 1977.

EXHIBIT A.

Opinion.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

ST. REGIS PAPER COMPANY, Plaintiff-Appellee, vs. ROYAL INDUSTRIES, and PLAS-TIES SUBSIDIARY, Defendants-Appellants. No. 74-3268.

ST. REGIS PAPER COMPANY, Plaintiff-Appellant, vs. ROYAL INDUSTRIES, and PLAS-TIES SUBSIDIARY, Defendants-Appellees. No. 74-3336.

Filed: April 19, 1977.

On Appeal from the United States District Court
for the Central District of California

Before: ELY and WALLACE, Circuit Judges, and SOLOMON,* District Judge.

SOLOMON, District Judge:

This case involves the validity of a patent on a plastic tie strip and a method for manufacturing the product. It also involves a license agreement for the patent rights and for the know-how used to manufacture the patented tie strips. The District Court held the patent invalid and permitted rescission of the license agreement. The Court denied the licensor royalties after the filing of this action, denied the licensee recovery of royalties paid before the filing of this action, and granted the licensor some compensation for its know-how. Both parties appeal.

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*Honorable Gus J. Solomon, Senior United States District Judge for the District of Oregon, sitting by designation.

Some time before June 1950, Gerald Bower formed a partnership to develop and market a plastic tie strip which could be used to tie bunches of fresh vegetables. In June 1950, the business was incorporated under the name of Plas-Ties Corporation (Plas-Ties).

On June 2, 1952, Bower filed an application for a patent on a plastic tie strip and method for making the tie strip. The Patent Office rejected all of Bower's original claims, but he later succeeded by amendments to the application in getting some claims allowed on a narrower basis. A patent (U.S. Patent No. 2,767,113) was issued to Bower on October 16, 1956 (the Bower patent). The patented device consists of two plastic strips reinforced by a wire between them. The wire is embedded in one of the plastic strips and secured with a "cementitious substance" so that the casing cannot slide from or bunch up on the wire. The wire permits fastening the tie by merely twisting it. The plastic outer casing permits easy handling and prevents the wire from cutting the stalks of the vegetables.

In April 1963, Bower assigned his patent to Royal Industries (Royal), and Royal acquired 80 percent of the outstanding stock of Plas-Ties. Bower owned the remaining 20 per cent of the stock, and he became president of Plas-Ties. In 1965, Royal acquired Bower's shares and Plas-Ties became a wholly owned subsidiary.

St. Regis Paper Company (St. Regis) supplies wrapping paper to the bakery industry through one of its subsidiaries, Pollack Paper Company. The use of tie strips significantly changed the packaging of bakery products in the early 1960's. The new method used

a tie strip around one end of the package instead of having the package tightly sealed at both ends. St. Regis lacked the technical ability to manufacture tie strips. The Bower tie strips and the machines Bower developed were suitable for bakery packaging.

On May 1, 1963, Royal and its subsidiary Plas-Ties (hereinafter referred to jointly as "Royal") entered into a license agreement with St. Regis. Under this agreement, Royal licensed St. Regis to use the Bower patent and Royal's know-how to manufacture and sell the patented tie strips. St. Regis agreed to pay Royal 10 per cent of its net dollar sales as royalties and also agreed to pay all reasonable expenses incurred by Royal in transferring its know-how to St. Regis. The agreement provided that it would terminate upon the expiration of the Bower patent in 1973.

Royal did make its know-how available to St. Regis. From 1963 to 1967, St. Regis paid Royal $174,642.04 for royalties and expenses.

Later, a dispute unrelated to this action arose between Royal and St. Regis on whether they had entered into an oral price fixing agreement. The dispute resulted in litigation between the parties.[1] In preparing for that litigation, St. Regis discovered evidence which it believed showed that Bower's patent was invalid. St. Regis stopped paying royalties after July 19, 1967. On April 24, 1968, St. Regis brought this action against Royal and Plas-Ties to declare the Bower patent invalid, to rescind the license agreement, and to recover royalties

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[1] *Royal Industries v. St. Regis Paper Co.*, 420 F.2d 449 (9th Cir. 1969). Royal brought the action against St. Regis for patent infringement and unfair competition. The District Court granted St. Regis's motion for summary judgment, and we affirmed on appeal.

it paid. In a counterclaim, Royal sued St. Regis for patent infringement.

The District Court held the Bower patent invalid. It also dismissed Royal's counterclaim. The Court held that St. Regis was entitled to rescind the license agreement, but denied St. Regis and Royal a money judgment against the other. In other words, the Court held that St. Regis could not recover the royalties it had paid, and Royal could not collect additional royalties under the license agreement. The Court awarded Royal the reasonable value of its know-how, but found that this amount had been fully satisfied by St. Regis.

Both parties have appealed. The appeals raise four issues:

(1) Is the Bower patent valid?

(2) If the Bower patent is invalid, is St. Regis entitled to recover royalties it paid to use the patent?

(3) If the Bower patent is invalid, is Royal entitled to recover royalties for its know-how?

(4) Is St. Regis entitled to attorney fees?

I. VALIDITY OF THE PATENT

The District Court held that the Bower patent was invalid for obviousness and because of a false oath, which failed to disclose that the patented product had been on sale for more than one year prior to the filing of the patent application.

A condition of patentability under the Patent Act of 1952 is non-obviousness. Section 103 of the Act provides:

> "A patent may not be obtained . . . if the differences between the subject matter sought to be

> patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains." 35 U.S.C. § 103.

Royal contends on appeal that the District Court failed to apply the proper standard for determining obviousness.

The issue of obviousness is ultimately a question of law, but the underlying analysis is one of fact. *Graham v. John Deere Co.*, 383 U.S. 1, 17 (1966). The Supreme Court in *Graham* set forth the standard for determining obviousness under Section 103. The court must determine the scope and content of prior art, the differences between the prior art and the claims at issue, and the level of ordinary skill in the pertinent art.

Here, the District Court determined that the prior art consisted of two lines of teachings. One consisted of tie strips manufactured and sold for more than a year before Bower applied for his patent. The other consisted of seven patents[2] which teach the use of a cementitious substance to bind wire or cord between two sheets of paper or other material.

The Court compared the teachings of the prior art with the claims of the Bower patent. It found that it was undisputed that tie strips manufactured and sold by Plas-Ties for more than a year before Bower applied for his patent were identical to the claims

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[2]Wisbrock patent, U.S. Patent No. 1,474,799; Schindler patents, U.S. Patent Nos. 1,910,510, 1,929,903, and 2,290,386; Crosby patent, U.S. Patent No. 2,577,843; Wick *et al.* patent, U.S. Patent No. 2,228,332; French patent, U.S. Patent No. 918,218.

of the Bower patent, except for the use of a "cementitious coating" in the Bower patent to bind the wire to the plastic strips. And the Court found that the Wisbrock, Schindler, Crosby, Wick, and French patents teach the use of a cementitious substance to secure wire or cord between pieces of paper or other materials in the same manner and for the same purpose as the Bower patent.

Finally, the Court accepted the testimony of St. Regis's expert witness (Dan Fischer) on the level of skill in the art. Fischer testified that in view of prior teachings and the prior public use of unbonded tie strips, the product claimed in the Bower patent would have been obvious to a person of ordinary skill in the art.

Royal also argues that the Court failed to give proper weight to the presumed validity of a patent. Any such presumption would disappear, or at least be weakened, when it is shown that all the prior art had not been brought to the attention of the patent examiner. 35 U.S.C. § 282; *Alcor Aviation, Inc. v. Radair, Inc.*, 527 F.2d 113, 115 (9th Cir. 1975), *cert. denied*, 426 U.S. 949 (1976).

Claim 1[3] of the Bower patent describes a product which depends both on the position of the wire (embedded in one of the plastic strips) and the use of a "cementitious coating" to bind the wire to the plastic strips. The District Court, based on the file wrapper,

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[3]"1. A plant-tie comprising: two ribbons of polyvinyl chloride joined face to face in parallel to form a unified strip; a wire disposed between said ribbons lengthwise thereof; one of said ribbons being flat and the other of said ribbons having a channel at least as deep as the diameter of said wire, in which said wire is embedded; and a cementitious coating on said wire for bonding said wire to said ribbons."

found that the patent examiner was persuaded to allow claim 1,[4] not because of the cementitious coating, but by the argument that Bower's positioning of the wire was a novel solution to the problem of enabling the plastic to get a good grip on the wire. Nevertheless, at the trial Royal did not dispute that more than a year before the patent application, Plas-Ties manufactured and sold tie strips which conformed in every respect to the claims of the Bower patent except for the use of a cementitious coating on the wire. These findings at least raised an issue whether Bower misrepresented the state of the prior art in his patent application and weakened the presumption of validity. *See Monroe Auto Equipment Co. v. Superior Industries, Inc.*, 332 F.2d 473, 482 (9th Cir.), *cert. denied*, 379 U.S. 901 (1964).

We hold that the Bower patent is invalid for obviousness. Because we affirm the District Court's holding of invalidity for obviousness, we need not reach the second ground, Bower's false oath.

II. THE LICENSE AGREEMENT

Under the license agreement, Royal licensed St. Regis to manufacture plastic tie strips using the Bower patent and Royal's know-how. In return, St. Regis agreed to pay Royal 10 per cent of net dollar sales in royalties.

The agreement provided for the possibility that the Bower patent might be declared invalid. Section 12(b)(1) of the agreement stated:

> "12. This agreement shall terminate upon the expiration of United States Patent No. 2,767,113,

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[4]The patent examiner at first rejected claims 1-4 of Bower's patent application. He was later persuaded to allow claim 4, which became claim 1 of the issued patent.

which is October 16, 1973, unless sooner terminated as hereinafter provided . . .

(b) Pollock may terminate this agreement after the expiration of three years from the effective date of this agreement by serving six months written notice on Royal to that effect, in the event that:

(1) Said Patent No. 2,767,113 is held invalid or so restricted in scope as to substantially lessen the protection of said patent by the final judgment of a court from which no appeal has been or can be taken. . . ."

St. Regis stopped all royalty payments on the basis of *Lear, Inc. v. Adkins,* 395 U.S. 653 (1969), but it did not comply with the procedure for terminating the agreement set out in section 12(b)(1).

The District Court held that section 12(b)(1) of the agreement was unenforceable under *Lear,* and that St. Regis did not have to pay royalties after the filing of this action.

The Court also held that St. Regis was entitled to rescind the agreement because the patent was invalid and because Bower knew the patent was invalid, which knowledge was imputed to Royal. The Court found that Royal was entitled to compensation for the know-how it conveyed to St. Regis and fixed the value of the know-how at $53,088.90. But the Court denied Royal payment on the ground that this amount had been fully satisfied by the royalty payments of more than $174,000, which St. Regis had paid Royal from 1963 to 1967. The Court disallowed St. Regis's claim for royalties paid before this action was filed.

A. *Refund of Royalties Paid*

In *Lear, Inc. v. Adkins,* 395 U.S. 653 (1969), the Supreme Court rejected the doctrine of licensee estoppel which prohibited a licensee from challenging the validity of his licensor's patent in an action for royalties under the license agreement. Under the *Lear* doctrine, a licensee can avoid payment of royalties withheld before the patent was declared invalid.

The question here is whether a licensee can recover royalties on a patent paid before filing an action in which the patent was found to be invalid. The Court in *Lear* was not faced with this issue because the licensee had paid no royalties after the patent was issued.[5]

St. Regis contends that under California law it is entitled to restitution of all royalties paid to Royal under the license agreement less the value of Royal's know-how. St. Regis relies on California Civil Code, Section 1692, which it contends provides for "automatic" restitution of benefits conferred when a contract is rescinded.

Section 1692 provides:

> "§ 1692 Relief based on rescission
>
> . . . The aggrieved party shall be awarded complete relief, including restitution of benefits, if any, conferred by him as a result of the transaction and any consequential damages to which he is

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[5]In *Lear,* the license agreement was entered into before a patent issued. Lear, the licensee, terminated all payment of royalties before the issuance of the patent. The Court held that Lear could avoid payment of royalties from the date of the issuance of the patent. In this case the license agreement was entered into more than six years after the patent issued. St. Regis paid royalties after the patent had issued, from 1963 to 1967, and it seeks to recover those royalties.

entitled; but such relief shall not include duplicate or inconsistent items of discovery.

If in an action or proceeding a party seeks relief based upon rescission, the court may require the party to whom such relief is granted to make any compensation to the other which justice may require and may otherwise in its judgment adjust the equities between the parties."

Section 1692 was designed to eliminate the confusing and complex duality of rescission procedures which existed in California by providing a single procedure to be followed in all cases where rescission is sought. *Runyan v. Pacific Air Industries, Inc.*, 2 Cal.3d 304, 466 P.2d 682 (1970). The provision permits a court in an action for rescission to grant any relief, including restitution and consequential damages, to which a party is entitled. It does not require restitution even when rescission is ordered. Restitution is discretionary with the court.

We believe that St. Regis is not entitled to restitution in this case due to overriding federal patent law policies.

The Sixth Circuit considered the *Lear* doctrine in light of the goals sought to be achieved and concluded that the federal policy which permits a licensee to assert invalidity of the underlying patent does not entitle the licensee to a refund of all royalties paid for the use of the invalid patent. *See Troxel Mfg. Co. v. Schwinn Bicycle Co.*, 465 F.2d 1253 (6th Cir. 1972) (*Troxel I*); *Troxel Mfg. Co. v. Schwinn Bicycle Co.*, 489 F.2d 968 (6th Cir. 1973), *cert. denied*, 416 U.S. 939 (1974) (*Troxel II*); *Atlas Chemical Industries, Inc. v. Moraine Products*, 509 F.2d 1 (6th Cir. 1974). *See also Zenith Laboratories, Inc. v. Carter-*

Wallace, Inc., 530 F.2d 508 (3d Cir. 1976), *cert. denied*, 45 U.S.L.W. 3250 (U.S. Oct. 5, 1976).

The Sixth Circuit noted that the Supreme Court in *Lear* rejected the estoppel doctrine on the ground that it effectively "muzzled" licensees who might be the only individuals with sufficient economic incentive to challenge the patentability of an invention. As stated in *Lear, supra*, at 668, "federal law requires that all ideas in general circulation be dedicated to the common good unless they are protected by a valid patent." This policy encourages full and free competition in the use of ideas which are in the public domain. *Lear*, therefore, is an inducement to an early adjudication of invalidity; but the Sixth Circuit cautioned that the possibility of a royalty refund might delay such a determination. The possibility of obtaining a refund of all royalties paid might induce a manufacturer to accept a license based on a patent of doubtful validity, derive the benefits of suppressed competition which the patent affords, and challenge validity only after the patent's expiration. The licensee would have a chance to regain all the royalties paid while having enjoyed the fruits of the license agreement. Therefore, if a refund were permitted, licensees who were only recently unmuzzled by *Lear* would again be silenced by economic self-interest rather than by state law.

We agree with the reasoning of the Sixth Circuit, and we hold that St. Regis is not entitled to the refund of royalties paid before it challenged the validity of the patent.

In *Troxel I, supra*, at 1259, n.5, the Court noted that it has been held without reliance on *Lear* that a licensee is entitled to recover royalties paid when

the licensed patent was procured fraudulently. St. Regis, relying on that comment, asserts that it is entitled to restitution because Bower obtained the patent by fraud. Even if fraud is a proper basis for allowing recovery of royalties, here the District Court found there was no fraud. The findings of the Court on this issue are not clearly erroneous.

B. *Payment for Know-How*

Royal contends that the District Court erred when it held section 12(b)(1) unenforceable. It asserts that the Court failed to distinguish between the payment of royalties for the patent rights and payment for the know-how. Royal concedes that if the patent is invalid, it is not entitled to the payment of royalties for the patent rights on the basis of section 12(b)(1); but it contends that section 12(b)(1) is valid and enforceable on royalties for know-how.[6]

Royal's know-how consisted of the knowledge of how the machinery used to manufacture plastic tie strips was constructed, and how this machinery operated. It included detailed information of the process for manufacturing the patent tie strips, a list of material suppliers, and work room dimensions. An employee of St. Regis

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[6]St. Regis contends that this issue was not properly raised on appeal because Royal made a binding election of remedies in its counterclaim when it implicitly accepted the termination of the license agreement and sued for patent infringement rather than for enforcement of the agreement. We do not agree.

Royal did not specifically seek to enforce the agreement in its counterclaim, but the pretrial order lists as an issue whether St. Regis was entitled to rescind the agreement. Royal at the trial asserted that it had a contract with St. Regis, that St. Regis breached the contract, and that Royal was entitled to appropriate relief. This was sufficient to prevent Royal from being precluded from seeking to enforce the license agreement on appeal.

spent several weeks at Royal's plant studying the manufacturing process. The District Court found that this know-how was fully revealed to St. Regis.

The Court found that Royal's know-how was not essential to the manufacture of the patented plastic tie strips, but was valuable to St. Regis because it permitted St. Regis to enter the plastic tie market sooner. St. Regis bargained both for the right to use the Bower patent and for the know-how needed to use the patent effectively. The know-how was closely related to the patent rights. This interdependence is reflected in the provision sought to be enforced.

Section 12(b)(1) provides that St. Regis may terminate the agreement if the patent is declared invalid. Royal's attempt to separate the know-how from the patent rights and to enforce the agreement for know-how alone is inconsistent with section 12(b)(1) and, we believe, contrary to the intent of the parties.

When, as here, the patent rights and the know-how are so intimately intertwined, we believe that the same rule which makes royalties for patent rights uncollectible if the patent is invalid should apply with equal force to know-how. This does not mean Royal will be deprived of compensation for know-how; it merely means Royal is not entitled to royalties under the license agreement, which did not distinguish between royalties for patent rights and royalties for know-how.

Royal urges us to address the broader question whether a contract for the payment of royalties for know-how is enforceable under *Lear*. But here we do not have a naked know-how license. In our view, the patent rights and know-how here are so intertwined that it

would be unreasonable to enforce the agreement for one and not the other.

We hold that section 12(b)(1) is unenforceable for both the patent rights and the know-how. Nevertheless, we believe that Royal is entitled to compensation for its know-how.

The District Court valued the know-how at $53,088.90. Royal asserts it is worth much more.

Although the Court ordered the contract rescinded, Royal urges us to value the know-how at one-half of the royalty rate because the parties placed this value on the know-how in discussions before the contract was executed. The contract as executed does not contain any such valuation. And the Court, after ordering rescission, was not required to place this value on the know-how even if it had been agreed to. Royal did not offer any other evidence on value. St. Regis suggested that the know-how be valued at $53,088.90, which represents a $20,000 advance on royalties paid by St. Regis before Royal permitted access to its know-how and one-half of the royalties paid through the second quarter of 1965, at which point the value of the know-how to St. Regis had become *de minimis*.

The District Court accepted this valuation. In our view, it is fairly generous. And in any event, it was the only evidence on the value of the know-how before the Court. The Court had a rational basis for this valuation, and we affirm this holding.

III. ATTORNEY FEES

In exceptional patent cases, the court may award reasonable attorney fees to the prevailing party. 35 U.S.C. § 285.

St. Regis contends that this is an exceptional case and that it is entitled to attorney fees. St. Regis asserts there are two factors which make this an exceptional case: Bower obtained his patent by fraud or material misrepresentation; and Royal knew or should have known that the Bower patent was invalid long before this litigation and yet it vigorously prosecuted this action.

The District Court rejected St. Regis's contentions and found that Bower's representations to the Patent Office were not motivated by fraudulent intent and that Royal had no knowledge of the infirmity of the Bower patent before trial.

The award of attorney fees is a matter of discretion, and a trial court may not be reversed except for abuse of discretion. *Hayes Spray Gun Co. v. E. C. Brown Co.*, 291 F.2d 319, 327 (9th Cir. 1961); *Pickering v. Holman*, 459 F.2d 403, 408 (9th Cir. 1972). There was no abuse here.

The judgment of the District Court is affirmed in all respects.

EXHIBIT B.

AGREEMENT

THIS AGREEMENT, effective as of the 1st day of May, 1963, is made between ROYAL INDUSTRIES, INC. and its subsidiary Plas-Ties Corporation (hereinafter called ROYAL), both corporations organized and existing under the laws of the State of California, having a place of business at Pasadena, California, and ST. REGIS PAPER COMPANY, a corporation organized and existing under the laws of the State of New York, acting by and through its Pollock Paper Company Division (hereinafter called POLLOCK), having a place of business at Dallas, Texas.

RECITALS

ROYAL has designed and developed a product line of plastic tie strips and is the owner of United States Patent No. 2,767,113, pending patent applications, and know-how pertaining to the design, manufacture, and machines and equipment for making plastic tie strips and for closing containers with said tie strips.

POLLOCK is desirous of manufacturing, using and selling the aforesaid product line and of acquiring a license under the patent rights and know-how owned by ROYAL.

Accordingly, ROYAL and POLLOCK hereby enter into the following agreement.

TERMS AND CONDITIONS

1. ROYAL grants to POLLOCK the exclusive right and license, without the right to grant sub-licenses, throughout the United States and its territories and dependencies under the aforesaid patent rights and

know-how to manufacture and sell the tie strips for use in the bakery packaging field, subject only to the right of ROYAL to manufacture, use and sell in the same field.

2. ROYAL grants to POLLOCK the non-exclusive right and license throughout the United States and its territories and dependencies under the aforesaid patent rights and know-how to manufacture and sell said tie strips for use in all other fields, subject to the right reserved by ROYAL to terminate said non-exclusive license in any segment of said other fields in which ROYAL during the life of this agreement, shall grant to a third party an exclusive license, either to the exclusion of ROYAL or subject to the right of ROYAL to manufacture, use and sell for use in the same field, provided that POLLOCK shall continue to enjoy said non-exclusive license in the fields of packaging frozen foods, paper toweling, toilet paper, produce bags, paper napkins, and related products sold by companies selling such products. ROYAL shall have the right to serve on POLLOCK written notice of any such termination and POLLOCK shall have no further rights in the field or fields designated in such notice after the expiration of one hundred eighty (180) days from the date of such notice.

3. ROYAL shall make available to POLLOCK the know-how now owned by ROYAL relating to said tie strips. POLLOCK shall have the right to order machinery and equipment for the initial manufacture of tie strips from ROYAL and ROYAL shall fill such orders in accordance with the terms of ROYAL's letters of April 24, 1963 and May 1, 1963 addressed to POLLOCK. However, POLLOCK shall have the

right to make or to have made by other sources such machinery and equipment as it may determine necessary to conduct operations under this agreement. ROYAL shall furnish POLLOCK with the necessary drawings and specifications to permit POLLOCK to have such machinery and equipment made. POLLOCK shall keep ROYAL informed with reference to any new machinery and equipment purchased or made hereunder. Upon termination of this agreement POLLOCK shall not have a license to manufacture, use or sell any machinery or equipment which is covered by unexpired patents owned by ROYAL relating to any inventions made by ROYAL prior to the date of this agreement, it being understood that plastic tie strip users of POLLOCK shall have the right to continue to use machinery and equipment for closing containers with plastic tie strips in use at the date of termination of this agreement.

4. POLLOCK shall reimburse ROYAL for all reasonable expenses incurred by ROYAL in the event one or more employees of ROYAL are requested by POLLOCK to travel to POLLOCK's plants for the purpose of making said know-how available to POLLOCK and POLLOCK shall also reimburse ROYAL for the time of any such employee's salary plus 200%. POLLOCK shall have the right to send authorized personnel of POLLOCK to visit ROYAL's plants where said tie strips are made and ROYAL shall make no charge to POLLOCK for such visits. The cost of preparation of any drawings and specifications in addition to those initially supplied to POLLOCK by ROYAL at the request of POLLOCK shall be borne by POLLOCK.

5. POLLOCK shall pay ROYAL royalties computed as follows:

Ten percent (10%) of the net dollar sales by POLLOCK. The net dollar sales shall be the invoice price less any cash discounts and less any actual transportation charges paid by POLLOCK and less any credits or allowances for returns.

If ROYAL reduces its selling prices below those set forth in the attached Exhibit A, said 10% royalty shall be reduced one percentage point for each 5% reduction in the selling prices, provided however the royalty shall not be reduced below 5%.

If ROYAL shall hereafter grant a license under said patent, said pending patent applications (or patents which may issue thereon), and said know-how, within the United States, territories & dependencies in the fields of packaging frozen foods, produce bags, paper toweling, toilet paper, paper napkins, and related products made and sold by companies selling such products, at rates of royalty lower than the corresponding rates provided in paragraph 5 hereof, then POLLOCK shall be entitled to the benefit of such lower royalty rate or rates for its operations in said fields of packaging bakery products, frozen foods, produce bags, paper toweling, toilet paper, paper napkins and related products, subsequent to such grant, but only for so long as and subject to the same conditions under which such lower royalty rate or rates shall be available to any such other licensee.

6. Each party shall promptly inform the other of any improvements developed or made during the life of this agreement in the manufacture or use of the plastic tie strips and machinery and equipment for making

and using the plastic tie strips, and each party shall have the royalty-free right to use any such improvements.

In the event that said improvements, made either by one party or by both parties jointly, result in a plastic tie strip or the method of making the same which is outside the scope of all of the claims of Patent No. 2,767,113, POLLOCK shall continue to pay royalties for the remaining life of the agreement but only at one-half the rates specified in Paragraph 5 hereof with the royalty rates being based on the selling price of the improved tie strips by POLLOCK.

7. POLLOCK shall pay ROYAL $20,000.00 upon execution of this agreement which shall be considered an advance on royalties due and payable within the first contract year from the effective date of this agreement, provided however that said first contract year shall be extended for the number of days in excess of 90 days required by ROYAL to deliver the initial machinery and equipment to POLLOCK in the event POLLOCK orders such initial machinery and equipment from ROYAL. If the earned royalties paid to ROYAL during the first contract year do not amount to said sum of $20,000.00, ROYAL shall retain the difference. If said earned royalties exceed said sum of $20,000.00, POLLOCK shall pay ROYAL the difference.

8. The royalties shall be payable quarterly on or before the 30th day after the end of each quarter calendar year. With each such royalty payment POLLOCK shall render to ROYAL a written report setting forth the tie strips sold during the preceding calendar quarter and the net dollar sales thereof.

9. POLLOCK shall keep true and full records of all of the tie strips manufactured, used and sold by it under this agreement. These records shall be open to the inspection of a certified public accountant selected by ROYAL and acceptable to POLLOCK annually during regular business hours at the expense of ROYAL.

10. POLLOCK shall use reasonable businesslike efforts to promote the sale and use of the tie strips hereunder. In the event that royalties payable by POLLOCK hereunder shall not amount to the minimums specified below, ROYAL may at its option by sixty (60) days written notice served on POLLOCK terminate this agreement. Failure of ROYAL to serve such notice within sixty (60) days after the end of any contract year shall be deemed to be a waiver by ROYAL of its rights to serve such notice for that contract year. If the actual royalties computed under Paragraph 5 hereof are less than the minimum for any contract year, POLLOCK shall have the right to pay the total minimum required in order to keep this agreement in effect. POLLOCK shall have the right to sell any said tie strips on hand on the effective date of such termination and to fulfill any contract obligations to customers, subject to payment of the royalties set forth in Paragraph 5.

Minimum Royalty Schedule

For the second contract year	$30,000.00
For the third contract year and each contract year thereafter	$50,000.00

All purchases by POLLOCK of plastic tie strips from ROYAL after the effective date of this agreement

shall be credited against the minimums above specified at the applicable royalty rate set forth in Paragraph 5.

After POLLOCK shall have paid to ROYAL the aggregate sum of $450,000.00 in royalties hereunder, ROYAL agrees to waive its right to terminate this agreement in the event the royalties paid to ROYAL by POLLOCK hereunder shall not amount to the minimum specified for any subsequent contract year.

11. POLLOCK shall use reasonable businesslike efforts to retain in confidence all know-how disclosed to POLLOCK by ROYAL hereunder but POLLOCK shall be under no such obligation of confidence with respect to know-how:

(a) Known to POLLOCK or in the public domain prior to disclosure thereof by ROYAL;

(b) Which shall become lawfully known to the public or become part of the public domain during the life of this agreement or thereafter; and

(c) Disclosed to POLLOCK by a third party.

POLLOCK will not communicate the know-how to any third party except to enable the manufacture of machinery and equipment for POLLOCK and to use and sell said tie strips, and POLLOCK shall require a statement in writing from such third party that it will retain said know-how in confidence.

12. This agreement shall terminate upon the expiration of United States Patent No. 2,767,113, which is October 16, 1973, unless sooner terminated as hereinafter provided.

(a) In the event POLLOCK shall default in the payment of royalties due hereunder or in the

rendition of quarterly reports, ROYAL shall have the right to terminate this agreement by serving 30 days written notice on POLLOCK calling attention to such default and in the event POLLOCK shall not have corrected any such default within said period of 30 days, ROYAL may terminate the agreement by serving 15 days written notice to that effect.

(b) POLLOCK may terminate this agreement after the expiration of three years from the effective date of this agreement by serving six months written notice on ROYAL to that effect, in the event that:

(1) Said Patent No. 2,767,113 is held invalid or so restricted in scope as to substantially lessen the protection of said patent by the final judgment of a court from which no appeal has been or can be taken; or

(2) ROYAL fails or refuses to file and prosecute a suit for infringement of said Patent No. 2,767,113 during the period of one hundred eighty days (180) after POLLOCK shall have given written notice to ROYAL, accompanied by evidence that said patent is being infringed (it being understood that ROYAL shall not be obligated to have pending more than one such suit at any one time); or

(3) A suit shall be instituted against ROYAL by an agency of the United States Government alleging violation of the law by ROYAL as a result of the grant of the rights and license herein granted, or as a result of manufacture and sale by ROYAL of the plastic tie strips licensed hereunder.

13. This agreement shall inure to the benefit of the successors and assigns of ROYAL. This agreement shall not be transferable by POLLOCK without the prior written consent of ROYAL except along with the transfer of all of the business of POLLOCK to which this agreement relates.

14. POLLOCK shall use an appropriate notice on all spools on which the tie strips are sold that said tie strips are licensed by Plas-Ties Corporation under the proper patent number, and patents pending.

15. Any notice required to be given hereunder by either party shall be given by sending the same, postage prepaid, by registered mail to the addresses set forth below, or to such other addresses as the parties may designate by written notice:

Royal Industries, Inc.

202 South Lake Avenue
Pasadena, California

Pollock Paper Company
Division of St. Regis Paper Company
Post Office Box 5325
Dallas, Texas

IN WITNESS WHEREOF, the parties have executed or caused this agreement to be executed as of the effective date set forth at the beginning of the agreement.

ROYAL INDUSTRIES, INC.
By /s/ J. R. Johnson
President

PLAS-TIES CORPORATION
By /s/ Illegible
President

ST. REGIS PAPER COMPANY
ACTING BY AND THROUGH ITS
POLLOCK PAPER DIVISION
By /s/ B. F. Lacy
Vice President
Pollock Paper Company
Division

ST. REGIS PAPER COMPANY
By /s/ Illegible
President

EXHIBIT C.

[Letterhead]

March 31, 1963

Mr. Leslie L. Jacobs
Huntington Hotel
Pasadena, California

Dear Mr. Jacobs:

In anticipation of our meeting tomorrow, I have enclosed some material that I feel will be helpful to you in your preparation.

I have taken the liberty to prepare a proposed agenda, which you may wish to modify; however, I am certain that our meeting can be speeded if we follow a planned course. We will accept any suggested modifications you may wish to make in the morning.

You will also find cost information on the Plas-Ties product, which is a result of our latest detailed cost study. We feel this cost study information to be quite accurate. You note this cost study shows only the prime cost factors and makes no provision for factory burden, or selling and G&A costs. You can readily apply your normal factors to determine quite accurately the margin of profit you can expect in manufacturing the Plas-Ties product. These figures indicate a handsome gross margin.

In addition, we have enclosed cost information on the product machinery. In this particular case, we applied a 200% burden to arrive at the manufacturing cost. The 200% factor is used as this is our normal burden in our Division whose principal activity is machinery manufacturing. In the event you wish to purchase a machine, our price will be negotiated on these

factors. Otherwise, this information will serve as a guide to the cost of manufacturing similar equipment.

You will also find a chart which demonstrates graphically our projections regarding growth of the Plas-Ties market in the bread wrapping industry. The chart is based on the installations of machines by the various machinery manufacturers and represents, in summary form, the detailed usage of these machines in 4" lengths of Plas-Ties. The vertical column on the left is the detailed usage of machines; the horizontal axis shows the approximate installation time of these machines. We feel this information to be conservative and quite accurate. We are in close touch with the various machine manufacturers, and our projection represents their planning as we have received it. You note up to April 1963 is based on "actual" installation of machines. Undoubtedly you have made a similar study.

We have taken the liberty of enclosing a write up on Plas-Ties, prepared by Jerry Bower, and the recent article that appeared in a local magazine. This will give you a better understanding of the company.

We have given considerable thought to the licensing program. Many factors affect our decision regarding royalty rates, and the type of license agreement we would like to work out. We will be prepared to discuss these with you tomorrow. To aid in your preparation, we feel very strongly that, though we will grant you an exclusive license for the bread wrapping industry, Plas-Ties will continue to sell to that industry. The licensing rate that we expect will be a rate based on 5% for our patent position, and 5% for our know-how. This 10% total royalty rate would apply to your sales volume of Plas-Ties. At the expiration of

the patent, which is approximately ten years, the 5% royalty rate for knowhow would continue for an additional five years. I am sure you agree that our efforts to date in developing this product, coupled with the gross margin existing in the product, merit this royalty amount.

In the event you care to discuss any of this information this evening, I can be reached at EL 5-1563. If I do not hear from you, I will expect to see you at about 8:30 a.m. Incidentally our office is a short distance from the hotel, and I would be pleased to pick you up, if you will either call me this evening or early in the morning.

Very sincerely,

ROYAL INDUSTRIES, INC.
/s/ J. R. Johnson
J. R. Johnson
President

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